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Such a disaster is somewhat like the "capsizing" of a ship which, under ordinary conditions, is always near stable equilibrium but which, after being tipped beyond a certain angle, has no longer this tendency to return to equilibrium, but, instead, a tendency to depart further from it.

Prof. Irving Fisher, "The Debt-Deflation Theory of Great Depressions"
***Journal of the Economic Society*, 1933**

FANTASY MEETS FACTS

In its just-published twice-yearly World Economic Outlook, the International Monetary Fund paints a rosy picture of the world economy. Still, it highlights one major risk to global growth: the vulnerability of the U.S. economy and the danger of its "hard landing" with "severe corrections in the stock market and the exchange rate." Stressing that huge increases in equity prices played a large part in fuelling the U.S. expansion, the IMF literally qualifies the U.S. economy as a "bubble economy." Slowly but steadily, this insight is spreading. What else than this recognition, by the way, could be behind the Fed's great hesitance in hiking its interest rates?

Stock market volatility has gone to unprecedented extremes of which it is very difficult to make any sense. Nor has there been a cataclysmal event that could explain this radical change in the climate of global stock markets. While the Fed and the European Central Bank have dutifully done a few modest rate hikes, money and credit remain as loose as ever.

Measured by the major stock indexes, this may not yet be a full-fledged bear market, but when measured by the numbers of shares that are falling, it definitely is. Considering further that Mr. Greenspan has no choice but to tighten until the U.S. economy visibly weakens, the bear case appears absolutely compelling. After all, he has succeeded in maneuvering himself into the worst possible position.

How bad will the financial and economic fallout be when the America bubble bursts? This will be the key issue among investors in the coming months. In this letter, we provide a comparative analysis of the economic and financial conditions in Japan, Europe and the United States, addressing a number of critical questions: How bad or good are the "fundamentals" of these three areas? Is Japan's economy recovering or heading into a debt trap? Once more: Is the United States in a "new paradigm" or a "bubble economy?" Will the dollar crash when the bubble bursts?

DIFFERENT MEASURES

Wondering about the euro's persistent weakness even in the face of a strengthening European economy, a headline in a well-known American paper caught our attention the other day: "Strong Yen Weighs on The Euro." In the text it said that the euro had suffered a sharp fall against the dollar, "battered by weakness against a surging yen." The text continued; "The yen rose after Japan reported a bigger-than-expected rise in industrial production, sparking optimism for the nation's economic recovery. That helped it rise against the dollar and the euro... The better-than-expected industrial-production number falls well in line with the market's optimism for Japan's recovery prospects..."

A few days later, the same paper carried another headline: "Yen Buoyed as Report Fuels Hopes for Japan." In immediate reaction to the reported news, even the dollar plunged against the yen from 105.485 to 102.73. And what was the sensational yen-boosting news? Japan's jobless rate had jumped to a new record high of 4.9%. What's so positive about that kind of news for a currency? According to the report, it was strongly "yen-supportive"

because the market interpreted the decline in employment as proof that "Japan is restructuring, paving the way for a more efficient economy."

You have to read and savor these two reports because they are exemplary of the diametric divergence in the treatment of economic news about Japan and Europe in the markets and the media. All news from Japan is principally good news; all news from Europe is bad news. Why? We quote from an article in the London Economist, published more than half a year ago: "Foreign investors seem utterly enamored of the corporate-restructuring story that Tokyo stockbrokers are peddling." In fact, much of the upward pressure on the yen against the euro comes from a massive switching of international equity investors out of Europe and into Japan.

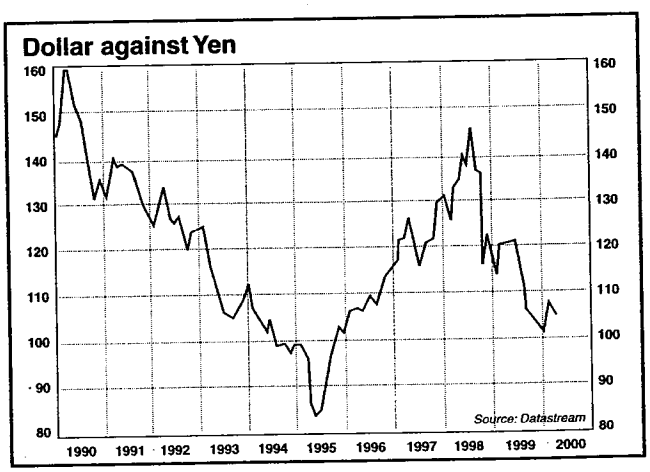
For many months, we have been insisting that the bull case for the Japanese economy is thin, very thin. Even if there are some spotty improvements, the overall economic picture continues to look desolate, quoting again the latest monthly report from the Bank of Japan: "clear signs of a self-sustained recovery in private demand have not yet been observed and wages continue to fall...The growth in money stock (M2+CDs) (lately 2.6% at annual rate) continues to slow reflecting stagnant private credit demand... In addition, firms continue to reduce debts as part of their balance-sheet restructuring measures."

During the three months to last December, Japan's economy actually contracted 1.4%. Annualized, this was 5.5%, following a decline of 3.8% in the third quarter. For the calendar year, the economy grew 0.3%, considerably less than expected. Gross domestic output has now fallen for seven of the last nine quarters. Yet for the umpteenth time, the government declares that the economy's recovery is on track. In just the same vein, the markets treat the news of persisting economic weakness, rising unemployment in particular, as positive reflections of successful corporate restructuring on the assumption that corporate cost reductions and downsizing, essentially, act as a drag on economic growth in the short run.

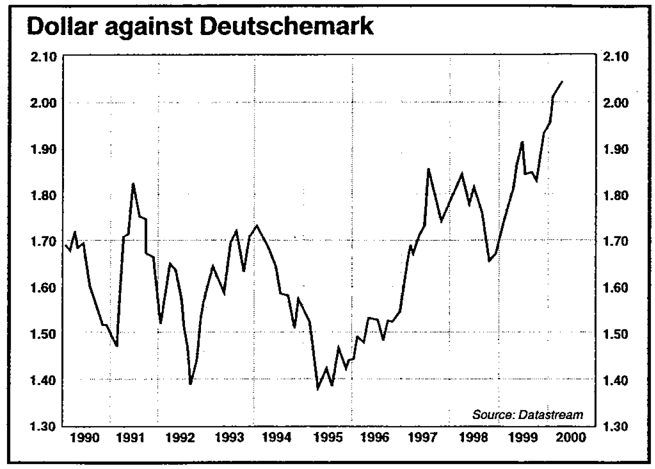
THE YEN MIRACLE

It has been a regular experience in history that weak economies have weak currencies and, inversely, that strong economies have strong currencies. In fact, this is the standard explanation for the euro's protracted weakness against the U.S. dollar. Yet, it obviously isn't an ironclad rule. Despite far more sluggish economic growth and near-zero interest rates in Japan, since the Asian crisis in the autumn of 1997 the yen has rocketed back in the currency markets, even against the super-strong dollar. After reaching a trough of 147 against the dollar in the summer of 1998, it has lately been hitting a peak of around 102 against the dollar, involving an overall appreciation by about 30%. Yet it required repeated heavy interventions by the Bank of Japan on the order of well over $50 billion to stave off an even steeper rise.

As we have repeatedly pointed out, the yen's abrupt reversal in late 1998 had its obvious, primary cause in the progressive unwinding of the so-called "yen carry trade." Foreign speculators had borrowed massively at ultra-low Japanese interest rates and sold the proceeds in favor of high-yielding currencies, especially dollars, offering a return far in excess of the borrowing costs incurred. Given the high leverage generally practiced, this game was critically dependent on the expectation of sustained yen weakness. This, however, was shattered in the autumn of 1998 by the troubles of the New York hedge fund LTCM in the wake of the Russian crisis. The associated scramble for liquidity forced many international speculators to unwind their huge short positions in the form of yen carry trade, implying correspondingly heavy sales of dollars.



These events triggered the initial sharp reversal of the



yen in later 1998. Propelled by rapidly accelerating capital inflows, which apparently reflected improving expectations about Japan's economic prospects, the currency's reversal soon became self-sustaining and self-reinforcing. The resulting massive demand for yen from foreign private investors sent the value of the currency soaring.

The yen's extraordinary strength has surprised us no less than the euro's extraordinary weakness. Neither makes any economic sense. Essentially, the explanation lies partly, if not largely, in the hazards of self-reinforcing, trend-following capital flows that are guided by nothing other than the lure of potential, short-run trading profits. There is really nothing new about this pattern of self-aggravating speculative drives under floating exchange rates. Still, one thing is new today, and that is the virtually limitless availability of credit facilities for financial speculation, including currency speculation. It inherently implies that there is virtually no limit to exaggerated changes in asset prices as well as in exchange rate movements.

JAPAN'S BULL STORY

It is reported that American investors in particular are captivated by the story that Japan's economy is intrinsically improving owing to vigorous corporate restructuring. Is that story for real, or is it just hype? To quote the latest OECD report on Japan:

Firms have increasingly been making claims that they intend to redeploy or sell their assets and restructure their businesses. The number of restructuring announcements has surged... But there is a legitimate concern as to whether many of the restructuring announcements will be truly carried out or whether, similar to the previous fad to grip the markets (share buybacks) they are being trotted out largely for the hoped-for favorable effect on the share price... Many restructuring announcements lack any target for cost cutting by which they can be judged, and others that do set such objectives often set the bar very low or rather distant.

As a matter of fact, we increasingly wonder whether the Japanese economy is fundamentally improving at all or, on the contrary, not even deteriorating. Definitely, it is not growing its way out of its economic and financial imbalances. One observation in particular has alarmed us. It is the recognition that the fiscal stimulus packages show a rapidly diminishing return in impacting the economy. Since August 1992, the government has launched 10 such packages, amassing in its course a staggering increase in new debt of $ 1,130 billion. Inexorably, the ratio of government debt to GDP over these few years has soared from about 60% to 105% of GDP in 1999.

Implicitly, the government during this period has run an average annual deficit of about 6% of GDP. But however dreadful this number is, the reality is even worse because this average masks a disastrous trend in the efficacy of the government's pump priming. As the following table shows, ever-bigger and bigger budget deficits since 1996 have delivered ever smaller and smaller GDP growth.

We would say that the numbers for the three years 1998-99 make absolutely dreadful reading. Just a modest

JAPAN: BUDGET DEFICITS AND GDP GROWTH (IN %)

	1996	1997	1998	1999	2000**	2001**
Government deficit *	- 4.3	- 3.4	- 6.0	- 7.6	- 7.9	- 7.2
GDP growth at market prices	3.5	1.5	-2.5	0.7	0.9	0.9
Real GDP growth	5.1	1.4	- 2.8	0.3	1.4	1.2

** in % of GDP ** official forecasts*

Source: OECD, Paris, Economic Outlook, December 1999

cut in the budget deficit in 1997 sent the economy promptly into a free fall in 1998. And then look at 1999: Even though the government instantly flooded the economy with new, record-high deficit spending, all it achieved was a brief economic flurry in the first half of the year, followed again by a new, sharp downturn in the year's second half. The miserable net effect for the year as a whole was 0.3% real GDP growth, after a disastrous plunge by 2.8% in the year before.

These fundamental facts are the appalling reality in Japan. But in the super-speculative markets of today, the game is not about reality; it is about attractive "stories" luring investors. For more than a year, U.S.-based international investment funds have charged out of Europe and back into Japan, boosting not just Tokyo stocks but also the yen. While the fundamentals both of Japan's economy and stock market are truly disastrous, the herd instinct of investors is powerful enough to ignore this. Taking about $60 billion out of European equities last year, this shift in investment flows has definitely played an important role in undermining the euro.

Essentially, this leaves us with two pertinent questions about Japan's economy: First, what were the cause or causes of this complete failure of "pump-priming" to restore self-supporting growth; and second, what are the prospects of future success or failure? Pump-priming, by the way, was the popular term in America in the 1930's for governmental deficit spending and relates to a process that was common in the days of the well and the cistern when a pump had dried up. It consisted of pouring water into the top of the dry pump and then vigorously working the handle until the pump began to operate in the normal way. It was an artificial expedient put into temporary use, but essentially it never succeeded unless the pump itself had been kept in good working order.

HOW SICK IS JAPAN?

Precisely the same applies to the attempts to restore self-sustaining growth in the private sector by pump-priming. In Japan's case, the combination of most prodigious budget deficits and near-zero interest rates for several years have piteously failed to reinvigorate economic growth in the private sector, even against the background of a strong global recovery. Attempting to assess the outlook essentially starts with identifying the causes of this deep and long economic slowdown.

What is the reason for this persistent policy fiasco? Faced with this question, most American economists can think of only one culprit: failure of Japan's central bank to act promptly when the stock market crashed and the economy began to weaken. Additional secondary reasons, generally recited, are stifling over-regulation of the economy and the financial system and inefficient corporate management breeding widespread inefficiency and poor return on capital. Any other reasons are, actually, beyond the grasp of most economists today.

Considering that until the bubble burst some 10 years ago, Japan's economy had been top in the world with persistent strong growth, booming exports and low inflation, we regard any talk of inefficient Japanese corporate management as utter rubbish. Our second major consideration is that Japan still has excellent economic fundamentals, allowing normally for sustained strong economic growth: high savings and investment ratios; a strong balance of payments; and zero inflation. U.S. economic fundamentals, actually, compare miserably with those of Japan. Yet Japan's economy refuses to be jump-started.

At issue in Japan's case is also the key question that is familiar from the discussion about the causes of the Wall Street Crash and the Great Depression of the 1930s. Was the collapse of the market and of the economy at that time the inevitable consequence of the excesses that had preceded it in the 1920s? Or was it the result of inept monetary policies after the crash during the 1930s? Could, in other words, alternative policies (that is to say, a looser monetary policy) have avoided the Crash and the Great Depression? In essence, this is Austrian theory against American Monetarism.

From a monetary perspective, Japan is the greatest paradox in the world. It has by far the lowest interest rates, near zero at the short end; yet money and credit growth are the lowest in the world, apparently suggesting that monetary policy is tight rather than lax. Broad money has been growing between 2.5-3.5% at annual rate. But what

role does this sluggish monetary expansion play? Is it cause or effect of the economy's sluggishness? We think it is far more effect than cause.

THE STRUCTURAL PREDICAMENT

The predicament of Japan's economy is clearly not just of cyclical and monetary nature. In the course of the bubble years and their aftermath, the economy has been afflicted with dramatic dislocations in its demand and output structures, associated with extreme movements of the currency. After all, Japan's economic dilemma is as significant as it is fascinating (significant because it is the world's second-largest economy, and fascinating because its economic predicament is unprecedented in kind and size in the post-war period.

Closer consideration leads to the realization that Japan's economy is in the grips of a savage deflationary spiral. It shows up spectacularly in the fact that the nonfinancial private sector, comprising both private households and businesses, is recording a ***persistent, large financial surplus*** of stunning size, equivalent to almost 10% of GDP.

What exactly does this mean? It implies, by definition, that the personal and the business sector together spend that much less than their total, current revenues. Instead, they are repaying debts and accumulating financial assets. As a result, private demand for goods and services keeps contracting. In order to fill the resulting big, chronic demand gap arising from the private sector, it has needed ever-larger injections of public deficit spending, running presently at 7% of GDP and higher.

While we read nothing but bullish reports about the outlook for Japan's economy, we deem this pattern of macro-economic development we have described (less and less economic growth with more and more public deficit spending) as out-and-out disastrous. Actually, it perfectly mirrors the dismal U.S. experience with cheap money and large budget deficits in the 1930s. But what strikes us as ominous in the case of Japan (see the table on page 3) is that the official growth projections for 2000-01 continue to presuppose the same dismal rates of economic growth on the one hand, and more of the same maximal government borrowing and spending on the other. Obviously, if it were not for the latter, the Japanese economy would be collapsing.

According to the conventional bullish reports about Japan's economy and stock market, the economy is gradually growing out of its troubles mainly owing to broad and faster American-style corporate restructuring and rapidly rising investment spending on information technology. The words "aggressive restructuring" have become a synonym for new economic vigor and efficiency.

We doubt that Japan's economy has even turned the corner from its worst recession. But above all, we don't see that American-style "corporate restructuring and cost cutting" are the proper devices to lead any economy out of a recession. Wall Street has good reasons to spread this doctrine, making fantastic profits on mergers and acquisitions. And millions of investors want to believe it because it seems to justify the stratospheric rise in stock prices that has enriched them. Nevertheless, it lacks proof and logic. To the extent that cost cutting, downsizing, mergers and acquisitions undercut new investment spending, they undercut economic growth and prosperity in the long run.

STRUCTURAL BREAK

Stated bluntly, American-style corporate restructuring will never lead Japan's economy out of its slump. Reductions in costs essentially imply equal reductions in income. The starting point for our critical assessment of the economic outlook in Japan is the big spending gap on the part of the private sector that we have earlier identified and pointed out. This gap reflects a persistent excess of saving over investment. To stop this contraction, it needs either an increase of investment spending up to the high level of saving or a decrease of saving down to the level of investment. Government spending, obviously, is but a palliative that in the long run may even do more harm than good. But what has caused this tremendous spending gap to arise in the first place? And what makes it so persistent?

Austrian theory says that the severity of a recession or depression is largely the function of the scale of the

dislocations and imbalances that have accumulated in the preceding boom. A further key axiom is that the credit excesses during the boom have a much deeper and more fundamental influence on the economy than that expressed in the inflation rate. The causes affecting the price level are too many to make it a reliable guide for monetary policy.

Of what kind are these "deeper and more fundamental bubble-related influences" that continue to impair economic growth in Japan? As we shall show, there are basically four different kinds. First, *dislocations in the demand and production structures;* second, *overindebtedness;* third, *price-cost disturbances;* fourth, *a distressed financial system.* To restore self-sustaining economic growth, it needs more or less prolonged, painful micro- and macroeconomic adjustment processes to correct these dislocations and disturbances.

In hindsight, it is manifest that the bubble years have wreaked havoc on Japan's economic and financial structures. A sharp rise in asset values tends to boost consumer spending through wealth effects and investment spending through lowering capital costs and increasing the firm's net worth that can be used as collateral for loans. In Japan's case, the bubble in stock and land prices had its chief economic outlet in business capital investment and commercial building. Between 1986 and 1990, business fixed investment surged by 55%.

We come back to the big spending gap of the private sector in Japan. On the surface, it has two primary causes. A persistently high level of savings is one. The low interest rates have by no means reduced personal saving. The decisive new factor behind the economy's prolonged sluggishness is sharply lower investment spending. As a result, Corporate Japan is running a financial surplus, and quite a big one for the first time ever since 1994. Owing in particular to rising capital depreciations and falling interest payments, the internal cash flow has overtaken current investment spending by a substantial amount. Clearly and definitely, this suggests a deep-seated structural break in the pattern of economic growth.

Japan's traditional growth pattern has been that the business sector has run a substantial financing gap, reflecting investment spending well in excess of internal cash flow. This gap used to be covered by the financial surplus (current savings) of private households. During the 10 years to 1975, for example, the corporate business sector had on average incurred an annual financing gap of 7.1% of GDP. This was more than matched by a financial surplus on the part of private households of 9.3% of GDP. A small government deficit and a small export surplus absorbed the rest of the available savings. In short, strong economic growth was geared to very high savings and investment ratios.

During the following 10 years to 1985, in the wake of the inflationary oil shocks, the pattern of economic growth changed drastically. Sharply lower capital spending curtailed the corporate financing gap to an annual average of 2.9% of GDP, while private households, in contrast, raised their financial surplus further to 10.2% of GDP. Soaring government deficits and a soaring export surplus took over from investment spending as the engines of economic growth.

FOUR POST-BUBBLE ADJUSTMENT PROCESSES

We come to the bubble years of 1986-90 and their evil legacy. The most significant bubble feature, as already mentioned, was an inordinate investment boom, actually propelling the corporate business sector's financing gap over these few years from 2% to a record-high of 9% of GDP. All too plainly, this investment rate was grossly out of line with the economy's long-term growth trajectory. The consequence: inordinate overinvestment turned into inordinate malinvestments.

When the bubble burst, Japan's economy was left holding a huge volume of accumulated over- and malinvestments in the form of corporate capital equipment, commercial buildings and (to a lesser extent) household durable goods, all of them requiring downward adjustment to the economy's much lower potential growth path. A significant part of the prolonged decline in the purchases of consumer durables, commercial building and corporate investment spending in recent years, implicitly, reflected this necessary "destocking" process correcting the spending excesses of the boom. Given the large scale of over- and malinvestments in the

bubble years, this adjustment process has played a major role in depressing Japan's economy for many years.

Spending excesses inherently imply debt excesses. During the five years from 1985 to 1990, the nonfinancial corporate sector in Japan doubled its debts. "Balance sheet adjustment" is the second, pernicious adjustment process. Inevitably, the burst of the equity and land bubble has left numerous corporations with badly impaired balance sheets that undermine their creditworthiness and thereby their ability to expand. In order to restore viable balance sheets, they sell assets or cut their investment spending which, however, both tend to intensify the deflationary pressures in the economy as a whole.

It is now 10 years since Japan's bubble burst. Is it conceivable that these adjustment processes have not yet been accomplished? It is not only possible but highly probable. And that has one reason: Healing weak balance sheets without self-defeating deflationary side effects depends crucially on higher profits. These, though, remain a disaster. There is much talk that corporate management in Japan has become more profit-oriented. Yes, but cost cutting and downsizing are recipes that tend to diminish profits in the aggregate. Business profitability in Japan is by far the lowest among industrial countries. In 1998, the consolidated corporate sector did not earn any net profits. Numerous companies are compelled to improve profits or face bankruptcy.

One of the well-known old economists, Wilhelm Roepke, has said; "In order to form an opinion on the policy of deflation and liquidation **it must be first recognized that every depression is a depression of profits** occasioned by the fact that the price curve and the cost curve cut." From a macroeconomic perspective, there is but one way to improve business profits *in the aggregate,* and that is to increase the business sector's overall revenue *without generating an expense.* For this, there are only four potential alternatives: lower personal savings, higher corporate investment spending, a rising export surplus or still higher government deficits.

What are the chances that one or several of these profit-enhancing flows will materialize? In the case of Japan, the normal escape route would be exports. But the soaring yen is barring it. The rising export surplus has more to do with shrinking import volume – reflecting weak domestic demand and falling import prices – reflecting weak domestic demand and falling import prices due to the appreciating yen – than with strong exports. In short, we don't see that any of these flows will occur at a sufficiently large scale to pull Japan's economy out of its deflationary spiral.

Yet there is still a fourth, major adjustment process to be taken into account, hampering economic growth. It concerns the banking system and its weak balance sheets derived of masses of bad loans that are the legacy of the bubble's burst. While the severity of the banking problems were well understood for many years, it was only in 1998 that the authorities made the first full-frontal assault on the banking crisis by providing up to 60 trillion yen (about $600 billion, 12% of GDP) to clean up the sector.

Given a widespread belief that the fragility of the banking system has been the single most important cause jeopardizing economic growth, the announcement of these measures has considerably contributed to the new optimism about Japan's economy. In our view, the far more important factor in stifling economic growth is the underlying tendency that costs are more resistant than prices, resulting in the poor profit performance. In a profitless economy, the credit machine is sure to remain idle.

We have taken a closer look at Japan's economy with one question uppermost in our mind. What is the basic cause of its protracted sluggishness? Is it due to policy mistakes made after the bubble burst? Or is it the inevitable aftermath of bubble-related damages?

In the first place, we would say that such a miserable economic performance which has lasted virtually 10 years now grossly exceeds the potential effects of any policy mistakes, provided it is a healthy economy. This protracted sluggishness in the face of near-zero interest rates and massive deficit spending by the government essentially implies that there are deeper-seated forces at work in the economy and the financial system obstructing the stimulative effects of these policies.

Earlier we identified four different adjustment processes as the chief stranglers of Japan's economic growth. But the all-important point about them is their origin. All four of them are the longer-term legacies of the economic and financial imbalances and dislocations that have accumulated during the bubble years under the impact of the credit excesses. The recognition of this correlation between these excesses and the present predicament of Japan's economy is the essence of Austrian theory.

EURO-MALAISE

Our inquiry into the ills of the Japanese economy has become a bit lengthy. We have undertaken it, however, with several important subjects in mind: euro weakness, dollar strength, the present U.S. bubble and its probable aftermath. Besides, we think the case of Japan's economy is an interesting illustration of how vastly economic perception and economic reality can diverge in today's markets.

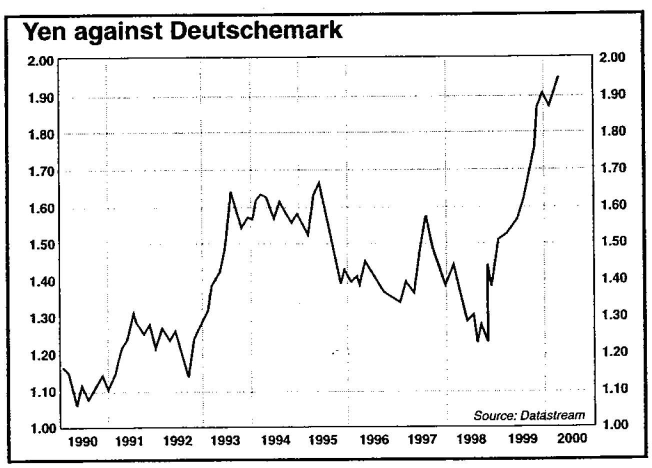
Typically bullish reports about Japan's economy have their regular counterpart in typically bearish reports about the euro-zone economy. Whatever happens in the area, most economists will find something negative that they stress. Just remember the uproar last year in the media and in the currency market when Italy asked the European Commission for permission to temporarily exceed the EU-stipulated budget deficit ceiling of 2% of GDP by quite a small amount. There was an immediate outcry that such fiscal laxity must spell inflation and disaster for the euro.

In 1999, the overall public budget deficit in the euro-zone averaged 1.5% of GDP. Italy, by the way, never exceeded the 2% limit. Now compare this number with Japan's monstrous budget deficit, being expected to run for years at more than 7% of GDP. Who cares? Who, at least, mentions it occasionally?

Recent news about Europe's economy actually make highly positive reading. Real GDP grew 4% at annual rate in the third quarter. For 2000, an overall real growth rate of 3.4% is predicted, after 2.3% last year. It also appears positively remarkable that the European Central Bank has been hiking its interest rates in the face of an average inflation rate of 2% in the euro area, having declared this as the acceptable limit for inflation. For sure, the situation is incomparably better than in Japan.

Yet, lots of good news about the euro economy are completely submerged in the currency markets by two considerations: first, that economic growth remains weak in comparison to that in the United States; and second, that European firms in general lack the necessary zeal for American-style corporate restructuring, while governments are not doing enough to liberalize their overregulated economies. If Japanese brokers do peddle the story of successful corporate restructuring in Japan, respected figures in Europe rather tend to confirm the negative image of Europe with critical remarks about lagging measures to reform the economy.

What's more, central bankers and politicians alike in Europe have systematically undermined the euro most of the time by numerous declarations to the effect that they didn't care about its slide as long as it did not fuel substantially higher inflation. To cap this, they incessantly trumpeted their further determination of strict non-intervention in the currency markets. If these people wanted a very weak euro, they couldn't have done better. No doubt, they did want it. Export-led economic growth has a long tradition in Europe.



Yes, but the creation of the unified European market has dramatically reduced the share of exports in the GDP of the area as a whole. Exports to third world countries account now for about 12% of the euro-zone's gross domestic product as a whole, compared to formerly more than 30% for the single countries. In other words, export stimulation

has greatly lost its thrust.

THE COSTS OF A SLIDING CURRENCY

On the other hand, the pervasive malign effects of the sliding currency, not only on the inflation rates but also on the terms of trade, business profits and interest rates, are ignored or grossly underestimated. There can be no question that these effects of the plunging euro have played a crucial role in mudding the picture of the European economy.

Take the terms of trade effect. It is widely believed that the falling euro has been crucial in bringing Europe back on its growth path. Indeed, export volume increased in the course of last year by 7%, while import volume declined by 2.6%. On closer look, though, this wonderful effect of the weak euro on foreign trade reveals itself as a great delusion. What counts for businesses and consumers in the last analysis are the effects of foreign trade on their incomes, resulting from changes in volume and prices. Despite shrinking volume, import values have soared by 21%, while exports, though booming in volume, increased in value only by 16%. The decisive point to see is that the positive income effects of the higher export volume have been overwhelmed by the negative income effects of the soaring import prices. Highly visible reciprocal effect of this trade-related income contraction is the shrinking surplus in foreign trade. But mind you, this is happening not despite the weak currency, but because of it.

To stress the decisive point: the income losses through the currency-related negative terms-of-trade effects substantially outweigh the income gains due to the currency-related increases in export volume. Putting it bluntly, the net effect of the weak euro on Europe's economy has been income contraction. American import prices, by the way, increased over the year by only 3%.

As a matter of fact, isn't it the lesson of history that currency weakness has regularly disappointed the expectations attached to it? It was the Bundesbank that has taught the world over many years the lesson of the pervasive "salutary effects" of a strong currency across the whole economy. Policymakers in many countries with a bias toward weak currencies took the lesson to the long-term benefit of their economies. Since the euro's introduction, Europe's policymakers have done their utmost to prove their complete defiance both of the lessons of history and of this legacy of the Bundesbank. Plainly, they have done a lot more than just tolerate the currency's slide. Too many public declarations on their part tended to convey the impression of utter indifference, if not even liking it.

Characteristic of their ambiguity are also the repeated public declarations of their firm determination to abstain under all circumstances from any interventions in the currency markets to support the euro. That's of course another discrete way to encourage already rampant speculation against the euro. The Bundesbank has rarely intervened, but it did not hesitate to do so when it saw excessive distortions. Actually, its interventions, which regularly proved highly efficacious, were greatly feared in the markets. This fear intrinsically curbed the speculation. Unquestionably, the old Bundesbank would have intervened long ago to stop this absurd decline of the euro. Consider that altogether Europe's central banks are sitting on a dollar hoard of more than $ 200 billion.

SOLID FUNDAMENTALS

Currency strength or weakness, nevertheless, in the longer run is determined not by perception, but by hard economic facts, and in this respect we rank the euro-zone economy well above the American and the Japanese economy. While there is nothing spectacular about its performance, there is something that we regard as most important to us: The absence of dangerous credit excesses and imbalances. Europe, too, has a stock market bubble, but it has not substantially spilled over into the economy. There is definitely no bubble economy, like in America.

What's more, there are solid economic fundamentals. A surplus of 44 billion euro in the current account

indicates a well-balanced economy. A gross investment ratio of 19% of GDP compares favorably with that in the United States. The big and highly positive difference to the United States is in the personal savings ratio, accounting in Euroland for 9% of GDP, as against almost zero in the United States. Last but not least, the inflation rate, presently 2.1%, is far below that of the United States. The virulent risk to Europe's economy does not lie inside Europe. It lies in the bursting of the American bubble.

"NEW PARADIGM" OR "BUBBLE ECONOMY"?

The U.S. economy in the last few years has become the envy of the whole world. So, of course, was Japan's economy 10 years ago. The "new paradigm" story says that the U.S. model of aggressive restructuring, supply-side reforms and widespread, rapid application of the new technologies has effectively paid off in an extraordinary period of strong economic growth, low inflation and a surging equity market. The "bubble" story says that all these effects are grossly overestimated. The main propellant of the U.S. economy was runaway credit creation, which through its various effects turned the U.S. economy into a bubble economy.

Take the U.S. inflation rate. Considering the strong dollar and the massive diversion of domestic demand into imports, America's present inflation rate of 3.7% appears shockingly high in today's global environment. Profits have been weak in the last two years even despite extensive cost and tax benefits from the escalating use of employee stock options. Above all, however, it strikes us as absolutely absurd to speak of big supply-side improvements in the case of an economy where savings have collapsed.

But the compelling evidence of a "bubble economy" is essentially in the money and credit figures. Mr. Greenspan has always maintained that it is impossible to identify a "bubble" before it bursts. If this is his true opinion, he reveals frightful ignorance in a question that belongs to the elementary part of economics. When does a credit expansion become "excessive"? It's hard to imagine a more important question, and economic theory happens to have a precise answer to it: A credit expansion becomes "excessive" (that is to say, inflationary) whenever it exceeds available savings. It is the function of interest rates to keep the two in equilibrium.

In the United States, total credit expanded last year by $2,200 billion, being divided half-and-half between the financial and nonfinancial sector (businesses and consumers). This compared with national savings of about $300 billion. To give an idea of the rate of acceleration: Two years before, in 1997, net credit growth had been $1, 416 billion. Or to use another plausible measure: In 1999, the $2,200 billion credit expansion coincided with nominal GDP growth of $495 billion. By any measure, America's credit figures for the last two to three years are horror figures. Again and again, it has infinitely astounded us that this compelling evidence of the "bubble" in the credit figures has been flatly ignored. As we have often mentioned, the word "credit" has never come from the lips of Mr. Greenspan.

"Excessive" credit growth is the primary condition of a "bubble economy," leading to the second question: What are the specific dislocating effects of the credit excesses on the economy? In the case of Japan, they went overwhelmingly into all kinds of investment spending. In the United States, they have primarily fueled the consumer borrowing and spending binge.

TRUE WEALTH...

If the U.S. economic "miracle" is attributable to high tech and the superiority of American corporate management, we keep wondering how this works. Let's, for argument's sake, assume that the productivity improvement is true and not a statistical fake. But what new technology can and does deliver is, strictly speaking, merely *potential* productivity growth. To transform this into *effective* productivity and associated income growth, it essentially needs the creation of additional demand. In the case of the Industrial Revolution, this demand and income creation largely took place through the capital- and labor-intensive production of the new machinery.

This is the key point: The burst in wealth and income creation in the course of the Industrial Revolution occurred overwhelmingly through building factories and producing new machinery. In other words, the demand creation derived largely from capital formation in the form of physical productive assets implementing the new technology.

...AND PSEUDO-WEALTH

To understand the great fallacies in the euphoria about the New Information Technology, you have to start with one question: How and where is the inherent wealth and income creation taking place? Through investment spending in the factories? Definitely not. Numerous tech companies with no earnings are burning wealth and capital, financing their losses by selling shares and bonds to the public. Apart from that, it is an important, negative characteristic of the information technology that the production of its instruments involves very little input in real resources, both of material and labor. In other words, it involves very little real capital formation.

Nevertheless, this technology has created wealth much faster and vaster than the Industrial Technology. But with a difference: This prodigious wealth creation in the wake of the Information Technology has occurred not in the factories. It has entirely accrued from the skyrocketing valuations that this technology has enjoyed in the stock markets.

American policymakers and many economists have a great liking for this particular kind of wealth creation, apparently thinking that saving and investment spending imply "sacrifices" by lowering consumption. Wealth creation through rising valuations in the stock market seems to involve no "sacrifice" at all. It arises literally out of thin air. Yet, as we see, it boosts consumption and living standards. Isn't that the best of all worlds? Isn't it part of the "new paradigm?"

The old economists, whom we like to ask for advice, would have given this kind of wealth creation quite a different label: *capital consumption*. This term refers to two ominous processes, which are the counterpart to the consumer borrowing and spending binge. The one is the soaring foreign indebtedness inherent to the booming imports, and the other one is the sharp rise of consumption as a share of GDP, essentially leaving lesser resources for investment spending. These are the only two methods how one generation can raise its living standard at the expense of following generations, and America is practicing both of them with reckless abundance.

WHEN THE U.S. BUBBLE BURSTS

We come to the final, critical question: What will happen when the U.S. bubble bursts? Disregarding all dislocations that the bubble has inflicted on the economy and the financial system, most American economists expect a soft landing, engineered by Mr. Greenspan through rapid rate cuts. Something like Japan's post-bubble malaise is absolutely inconceivable to them.

We have described in some detail the various bubble-related adjustment processes that are strangling Japan's economy in order to convey a general idea of the complexity of contractive forces at work in the economy as a legacy of the bubble. A steep and definite fall of share prices will unleash the very same painful adjustment processes in the United States.

It is often argued that the U.S. bubble is less damaging because it chiefly boosted consumer spending, not investment spending. There would therefore be no overhang of vacant condominiums or idle industrial capacity depressing future investment spending. To quote Professor Paul Krugman, "It's paper gains today, paper losses tomorrow; who cares?"

Remarkably, Professor Krugman calls the "wealth creation" in the stock market by its proper name: paper wealth. In the economic literature, this kind of "wealth" has variously been called "imaginary" or "pseudo" wealth.

Back to Prof. Krugman and his comforting reflections about the U.S. bubble, which seem to have many

sympathizers. To begin with, we can only repeat and stress our earlier remark: Decisive, in the first place, is the size of the bubble's impact on the economy. Krugman argues further that debts can become a big problem only when businesses, in particular real estate developers, overborrow.

Consider the American facing huge losses on his equity holdings, plus his indirect holdings in pension funds but unchanged debt levels. For sure, he will voluntarily or involuntarily drastically prune his spending. What would, for example, a mere return to the savings ratio of the past, around 5-6% of his disposable income, do to the economy, to profits etc. It would push the economy into prolonged, deep recession, so deep that interest rate reductions would be ineffective.

In reality, as we have tried to illustrate on the example of Japan, the reverberations of a bursting bubble on the economy and the financial system are far more pervasive. Above all, there are sure to be extremely severe repercussions on the banking system and business profits. Perhaps even more than in Japan, the booming stock market in the United States has super-inflated profits. Think of the enormous benefits to profits by the heavy use of stock options and by the fact that stock market gains have replaced corporate cash contributions to pension funds.

May we recall the postulate of Austrian theory that there is a reciprocal correlation between the severity of boom and bust. From this perspective, the U.S. economy is the worst case ever of a bubble economy. The extent of the credit excesses simply defies description and imagination, considering in addition the depleted savings. Overwhelmingly, this financial system is based on nothing but leverage upon leverage. There must be looming numerous, very bad surprises looming, putting it cautiously.

The other dangerous complication derives from the preposterous deficit in the current account and potential repercussions on capital flows and the dollar. Once the perception develops that the U.S. economy is weakening, the dollar is certain to follow suit. Accelerating economic weakness will accelerate the dollar's decline. When the "bursting bubble" finally shatters the prevailing complacency, we see the dollar plunging to new lows against the European currencies.

CONCLUSIONS:

The U.S. bubble is in its late stages. Yet unmitigated bullishness and complacency prevail. Financial markets remain convinced that the Fed will finally succeed in pulling off the ever-elusive benign soft landing. But excesses and imbalances in the economy and the financial system are far too big to allow this to happen. An extremely aggravating factor for the whole world will be the inevitable dollar crisis.

The crucial, dangerous phase for global stock and currency markets will begin when the U.S. economy begins to show definite signs of weakening.

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